PROCEDURE NO.

801

# Distinguishing Between Supplies and Capitalized Equipment

One common accounting challenge LEAs face is that of distinguishing between supplies and capitalized equipment, between capitalized equipment and improvement of grounds, and between capitalized equipment and building fixtures or service systems. LEAs must correctly identify each expenditure if they are to achieve the necessary uniformity of accounting.

Whether an item should be classified as capitalized equipment or as supplies is determined by the length of time the item is serviceable and on its contribution to the value of the physical assets of the LEA. For example, supplies are constantly consumed and replaced without substantially increasing the physical assets of the LEA. Capitalized equipment has relatively permanent value and substantially increases the value of the physical assets of the LEA.

Expenditures for capitalized equipment, improvement of sites, building fixtures, and service systems are charged as capital outlay. Expenditures for noncapitalized equipment, supplies, and noncapitalized improvements are charged as current expense.

## Criteria for Distinguishing Between Supplies and Equipment

Supplies are items of an expendable nature that are consumed or worn out, deteriorate in use, or are easily broken, damaged, or lost.

It is sometimes difficult to classify some articles as either supplies or capitalized equipment. They have the characteristics of equipment but may have a low unit cost or are frequently lost, broken, or worn out and replaced in normal use. To obtain uniformity, the LEA should assign items to the various classifications on the basis of answers to the questions below:

1. Does the item lose its original shape and appearance with use?

2. Is it consumable, with a normal service life of less than one year?

3. Is it easily broken, damaged, or lost in normal use?

4. Is it usually more feasible to replace it with an entirely new unit than to repair it?

5. Is the cost of the item below the LEA’s capitalization threshold?

If the answer to any one of the preceding questions is yes, the item should be classified as a supply item, and the expenditure should be recorded within Object 4000, Books and Supplies. If all the answers are no, the item should be classified as capital outlay, and the expenditure should be recorded within Object 6400, Equipment, or 6500, Equipment Replacement.

The federal government uses the following flowchart to distinguish capitalized equipment from supplies. At the first NO, the item is declared to be a supply, not capitalized equipment.

Criteria for Distinguishing Capitalized Equipment from Supply Items
(Listed in Priority Order)

Lasts more than one year → NO

↓ YES

Repair rather than replace → NO

↓ YES

Independent unit rather than being incorporated into another unit item → NO

↓ YES

Cost of tagging and inventory small percentage of item cost → NO

↓ YES

Exceeds minimum dollar value established by the LEA → NO

↓ YES

EQUIPMENT

At the first NO, the item is declared to be SUPPLY.

**Inventory vs. Capitalization**

Property inventory requirements and capitalization thresholds are different subjects that are commonly confused because of their overlapping terminology. An inventory is an itemized list for tracking and controlling property. Capitalization is an accounting treatment whereby an item of property is recorded as an asset rather than as an expense of the current period. Capital assets are those assets that meet the estimated useful life and monetary cost criteria and warrant capitalization in the financial statements. All items owned by an LEA can rightfully be considered assets, but as a practical matter, LEAs do not need to capitalize all of them.

*Education Code* Section 35168 requires LEAs to maintain an inventory of equipment whose current value exceeds $500. This requirement does not mean that LEAs must capitalize equipment costing more than $500. While all capitalized items should be inventoried, not all inventoried items should necessarily be capitalized. LEAs should maintain inventories—for compliance, accountability, and internal control purposes—of many items they do not capitalize in their financial statements. For example, LEAs might want to inventory VCRs and computers for internal control purposes, but might not want to capitalize them because of their low cost.

**Capitalization Threshold**

Capitalization threshold is the per-unit cost at which a given item qualifies for capitalization. Capitalization thresholds may differ from one LEA to another, depending on materiality; typically, the larger the LEA, the higher its capitalization threshold. The Government Finance Officers Association (GFOA) recommends that the threshold amount be set so that about 80 percent of the dollar value of an LEA's assets are reported (not 80 percent of the LEA's individual items of property). The Office of Management and Budget (OMB) Circular A-87, *Costs Principles for State, Local, and Indian Tribal Governments,* allows property costing up to $5,000 to be charged to federal grants as supplies, rather than as equipment, unless the LEA has set a lower capitalization threshold.

For most LEAs a capitalization threshold of at least $5,000 is recommended. For larger LEAs a higher capitalization threshold may be appropriate. If an LEA elects to set a threshold higher than $5,000, it needs to have a separate threshold of $5,000 for items paid for with federal funds. It is recommended that LEAs set a similar threshold for items paid for with restricted state funds. It is further recommended that LEAs consider capitalizing any item acquired through long-term debt such as a capital lease, even if the item does not otherwise meet the LEA's threshold for capitalization. This ensures that when the LEA reports the liability for the long-term debt, the LEA will also report the corresponding asset for which the debt was issued.

LEAs may wish to establish a separate, higher threshold for capitalization of site and building improvements than for capitalization of equipment. This part of the capitalization threshold should probably include a "common-sense" component whereby only those improvements that meet the threshold for capitalization AND that significantly enhance the value or extend the life of the site or building, regardless of the cost, are capitalized.

**Reconciling Property Inventories to Accounting Records**

LEAs have the ability to reconcile their property inventories, whether the property was capitalized or noncapitalized, to their accounting records.

It is relatively easy to reconcile inventoried items of capitalized property to accounting records because items of property that are capitalized should also be inventoried. To make it easy to reconcile inventoried items of noncapitalized property to accounting records, LEAs should use Object 4400, Noncapitalized Equipment, to distinguish expenditures for noncapitalized but inventoried items of property from expenditures for other materials and supplies.

For example, assume that an LEA maintains an inventory of items of property costing more than $500. The LEA would charge expenditures for items of property costing more than $500 to Object 4400, Noncapitalized Equipment. The LEA would charge items costing less, such as pencils and staplers, to Object 4300, Materials and Supplies. It would be easy to reconcile inventoried items of noncapitalized property to the accounting records.

## Criteria for Repairs, Maintenance, and Betterments

Repair parts that the LEA purchases for buildings, equipment, and grounds, regardless of cost, are normally charged as supplies.

**Examples: plumbing fixtures, compressors (if part of a larger unit), bus transmissions, engines, and timer devices for automatic sprinkler systems**

Repair costs are those outlays that are necessary to keep an asset in its intended operating condition but that do not materially increase the value or physical properties of the asset.

In contrast, all additions and betterments to fixed assets should be charged to a capital outlay account when acquired or when construction or installation is completed. An addition refers to a physical extension of some existing asset. A betterment exists when a part of an existing asset is replaced by another and the replacement provides a significant increase in the life or value of the asset.

## Criteria for Identification of Capital Outlay

Capital outlay expenditures are those that result in the acquisition of capital assets or additions to capital assets. They are expenditures for sites, improvement of sites, buildings, improvement of buildings, building fixtures, service systems, and purchase of initial or additional equipment that meet the LEA's threshold for capitalization and substantially increase the LEA's assets.

6100—*Sites and Improvement of Sites*

Sites and Improvement of Sites includes acquisition of land, improvement of new and old sites and adjacent ways, and acquisition of physical property of a permanent nature attached to land. In addition to purchase price, the recorded costs should include such items as legal and title fees, surveying fees, appraisal and negotiation fees, damage payments, site preparation costs (clearing, filling, and leveling), and demolition of unwanted structures.

**Examples:** **land, curbs, grading, playground surfacing, retaining walls, sidewalks, storm drain systems, landscaping, driveways, parking lots, fixed playground apparatus, and flagpoles**

6200—*Buildings and Improvement of Buildings*

**Buildings**

Buildings include the construction or purchase costs of new buildings and additions, including advertising costs, architectural and engineering fees, blueprints, inspection, tests and examinations, demolition, the razing of existing obsolete or old buildings to clear sites for new buildings, building fixtures and service systems, and any other expenditures directly related to the construction or acquisition of buildings.

**Improvement of Buildings**

Improvement of buildings includes alterations, remodeling, renovations, and replacement of buildings in whole or in part. Improvements include the replacement of an existing building unit or construction of an improved or superior unit, usually resulting in a more efficient or a longer-lasting property. Significant improvements that meet the LEA's threshold for capitalization should be considered as capital outlay expenditures.

## Criteria for Identification of Building Fixtures and Service Systems

The following criteria provide a uniform basis for the identification of building fixtures and service systems. To be classified as either a building fixture or a service system, as opposed to maintenance, an item must conform to five criteria:

1. The item is attached permanently to the building.

2. The item functions as part of the building.

3. Removal of the item would result in appreciable damage to the building or would impair the designed use of the facility.

4. The item is generally accepted as real property (not personal property).

5. The item loses identity as a separate unit.

**Building Fixtures**

Building fixtures include attachments to a building that are not subject to transfer or removal, presumably function as integral parts of the building, and have fairly long and useful lives. Such fixtures are generally accepted as real property and lose functional identity as separate units.

**Service Systems**

Service systems include any parts of a building that are intended to serve a single function throughout the building, are usually included as a part of the original construction or subsequently added in whole or in part, are built as integral parts of buildings, and are expected to have long and useful lives. Such systems are generally accepted as real property and lose identity as separate units.

**Examples: air-conditioning systems or intercommunication systems**

6300—*Books and Media for New School Libraries or Major Expansion of School Libraries*

Books and media for equipping new school libraries or a major acquisition of books and media for the purpose of expanding existing libraries should be charged as capital outlay.

6400—*Equipment*

Equipment means an item of movable personal property of a relatively permanent nature having an estimated useful life greater than one year and an acquisition cost that meets the LEA's capitalization threshold. If equipment is constructed by LEA employees, the cost of the materials and labor as well as indirect costs should be recorded as the total cost of the item that is produced.

**Examples: computer network hardware and buses**

6500—*Equipment Replacement*

Equipment replacement includes the replacement of movable personal property as defined in Object 6400, Equipment.